Office of the Auditor General

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FIRE AND HAZARD INSURANCE FOR FARMS AND HOMES PURCHASED UNDER THE CAL-VET PROGRAM ADMINISTERED BY THE DEPARTMENT OF VETERANS AFFAIRS

FEBRUARY 1975

TO THE

JOINT LEGISLATIVE AUDIT COMMITTEE

STATE OF CALIFORNIA

Office of the
Auditor General

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February 14, 1975

Honorable Bob Wilson
Chairman, and Members of the
Joint Legislative Audit Committee
Room 4126, State Capitol
Sacramento, California 95814

Dear Mr. Chairman and Members:

Transmitted herewith is our report on fire and hazard insurance for farms and homes purchased by California veterans under the Cal-Vet Program administered by the Department of Veterans Affairs. Presently, such insurance is purchased by the department from the Hartford Fire Insurance Company and the National American Insurance Company, with total insurance coverage for 115,600 Cal-Vets amounting to approximately $3.2 billion. Premiums are paid by Cal-Vets through the department.

As a result of the Department of Veterans Affairs not having statutory authority to self-insure against fire and hazard coverage for farms and homes purchased under the Cal-Vet Program, Cal-Vets have expended an estimated $14.3 million in excessive insurance costs from December 1960 through December 1974.

Included in the $14.3 million is estimated interest income of $9.6 million which was lost by the Cal-Vets because premium payments were prepaid to insurance companies at the beginning of the policy period, whereas the fire and hazard insurance claims were paid out by the insurance companies during the policy period. Therefore, Cal-Vets lose the interest which would have been earned if the Department of Veterans Affairs were able to have invested the prepaid premium monies until the claims had to be actually paid.

Although a self-insurance program would result in savings to Cal-Vets, currently such a program for fire and hazard insurance is prohibited by the Military and Veterans Code. The department has not requested legislation to amend the code which would permit such a self-insurance program to be established.

We estimate that a self-insurance program, in lieu of purchasing insurance from outside insurance companies, would result in reduced costs of $1 million annually to Cal-Vets.

We recommend that legislation be enacted in order that the Department of Veterans Affairs can establish a self-insurance program for fire and hazard insurance on farms and homes purchased under the Cal-Vet Program.

Respectfully submitted,

Harvey M. Rose
Auditor General

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INTRODUCTION

In response to a legislative request, we have reviewed the procurement of insurance by the Department of Veterans Affairs.

The department currently obtains three forms of coverage for California veterans:

- Fire and hazard insurance
- Life and disability insurance
- Disaster insurance.

This report is concerned with the fire and hazard insurance for farms and homes purchased under the Cal-Vet Program administered by the Department of Veterans Affairs. The insurance is purchased by the Department of Veterans Affairs on a master policy from the Hartford Fire Insurance Company and the National American Insurance Company with individual certificates of insurance being issued to individual Cal-Vets. The premium for the fire and hazard insurance is paid by the department and then is reimbursed by the Cal-Vets over the life of the certificate. From 1970 to present, certificates of insurance are issued by Hartford for three-year periods and the National American's certificates were issued for five-year periods from 1960 to 1970. Certificates issued by National American in 1970 will expire in 1975. As of December 1974, the Hartford has 96,500 contracts with coverage on $2,726,000,000 and the National American has 19,100 contracts with coverage on $485,000,000.

FINDINGS

AS A RESULT OF THE DEPARTMENT OF VETERANS AFFAIRS NOT HAVING STATUTORY AUTHORITY TO SELF-INSURE AGAINST FIRE AND HAZARD COVERAGE FOR FARMS AND HOMES PURCHASED UNDER THE CAL-VET PROGRAM, CAL-VETS HAVE EXPENDED AN ESTIMATED $14.3 MILLION IN EXCESSIVE INSURANCE COSTS FROM DECEMBER 1960 THROUGH DECEMBER 1974.

The Department of Veterans Affairs does not have the statutory authority to establish a fire and hazard self-insurance program covering farms and homes purchased under the Cal-Vet Program. As shown in the table on page 3, if such authority had existed and had been exercised by the department, California veterans would have expended an estimated $14,298,000 less between December 1960 and December 1974 through having a self-insurance program rather than purchasing fire and hazard insurance from outside insurance companies. The appendix on page 9 of this report contains an analysis of the estimated reduction of $14,298,000 in expenditures assuming that all coverage was canceled as of December 31, 1974.

Estimated Reduction in Expenditures Assuming
The Cal-Vet Program Was Self-Insured For Fire and Hazard Coverage
For the Period December 1960 through December 1974

	Self-Insurance Program Costs	Insurance Costs By Contracting With Outside Companies	Excess Of Insurance Costs By Contracting With Outside Companies Over Self-Insurance Program Costs
Premiums paid to outside insurance companies		$29,796,000	$29,796,000
Actual losses (claims) paid to Cal-Vets	$24,617,000	--	(24,617,000)
Administrative expenses of self-insurance program	565,000	--	(565,000)
Lost interest income	--	9,684,000	9,684,000
Estimated savings by self-insuring fire and hazard coverage rather than purchasing insurance from outside companies	$25,182,000	$39,480,000	$14,298,000

As can be seen above, a self-insurance program would have resulted in an estimated reduction in costs of $14,298,000.

As a result of not having a self-insurance program, estimated interest income of $9,684,000 was lost because premium payments were prepaid to insurance companies at the beginning of the policy period, whereas the actual fire and hazard losses (claims) were paid out by the insurance companies during the policy period. Therefore, Cal-Vets lose the interest which would have been earned if the Department of Veterans Affairs were able to have invested the prepaid premium monies until the claims had to be actually paid.

The $29,796,000 of premiums in the table on the preceding page is the amount of premiums for fire and hazard insurance paid to insurance companies by the Department of Veterans Affairs for the period December 1960 through December 31, 1974, less the estimated $5,700,000 prepaid portion of unearned insurance premiums which were refundable to the department as of December 31, 1974. The $5,700,000 would have been refunded to the department by Hartford and National American if these insurance contracts had been canceled as of December 31, 1974. Losses of $24,617,000 consist of the actual losses paid by the insurance companies of $23,357,000 through December 31, 1974 and the estimated unpaid losses of $1,260,000 through that date.

The cost of administrating a self-insurance program was calculated at 11 percent of the Hartford's losses, or $565,000. This represents the cost of administration, based on prior experience, which we estimated would have been incurred by the department if the Hartford contract were self-insured. The cost of administration was based upon the experience of the department with the National American contract for which the department performed administrative functions.

No administrative expenses were included in the analysis for losses under the National American contract since the department is required to perform the administrative functions under this contract.

Lost interest earnings of $9,684,000 calculated quarterly were computed using the actual rate of interest earned by the Pooled Money Investment Board from December 1960 through December 31, 1974.

Under a self-insurance program the Department of Veterans Affairs would establish an actuarially sound fund to pay for insurance losses and administrative expenses. Premiums would be paid by the department to the self-insurance fund rather than to outside insurance companies. Cal-Vets would reimburse the department for the premium costs.

It may be necessary initially to obtain a general fund appropriation to initiate a self-insurance fund. However, in our judgment, the refund of unearned insurance premiums by the insurance companies to the department, if a self-insurance program were initiated, would make an additional general fund appropriation unnecessary. Such a refund would currently approximate $5,700,000.

Although a self-insurance program would result in savings to the Cal-Vets, currently self-insurance for fire and hazard insurance is not authorized by the Military and Veterans Code. Legislation would be necessary to permit self-insurance. The department has not requested legislation permitting self-insurance.

In a 1970 report of the Insurance Office of the Department of General Services, it was stated that the three elements necessary, from a risk management approach, to have a self-insurance program for fire and hazard coverage are present in the Cal-Vet Program. The three elements are:

- Large number of properties
- Wide distribution of properties
- Relatively small single units of exposure.

The department has the expertise to administer the self-insurance program for properties insured for fire and hazard coverage since the department collects the premiums from individual veterans, investigates the claims and pays the losses under the National American contract.

In November 1974, the Hartford Fire Insurance Company informed the department of its intention to cancel its coverage on July 1, 1975 because of the department's unwillingness to increase the rates without competitive bidding. The department in conjunction with the Insurance Office of the Department of General Services has prepared bid specifications to replace the coverage on July 1, 1975.

Based on prior experience, we estimate that a self-insurance program, in lieu of purchasing insurance from outside insurance companies, would result in reduced costs of $1 million annually to Cal-Vets net of administrative expenses.

CONCLUSION

A self-insurance program for fire and hazard insurance would be more economical to Cal-Vets than insurance coverage obtained through outside insurance companies.

RECOMMENDATION

We recommend that legislation be enacted in order that the Department of Veterans Affairs can establish a self-insurance program for fire and hazard insurance on farms and homes purchased under the Cal-Vet Program.

SAVINGS

Implementation of this recommendation will reduce the cost of fire and hazard insurance for Cal-Vets by an estimated $1 million annually net of administrative expenses.

SUMMARY OF COMMENTS OF THE DIRECTOR OF VETERANS AFFAIRS AND HIS STAFF AND THE INSURANCE OFFICER OF THE DEPARTMENT OF GENERAL SERVICES

1. If such a self-insurance program is approved by the Legislature, the department must be allowed a reasonable time for implementation -- at least a year.

2. The effect of a self-insurance program on the marketability and interest rates of bonds sold for the department should be explored before such a program is implemented.

3. Consideration should be given to the effect such a self-insurance program would have on the insurance premium tax of 2.35 percent of the premiums now paid by the insurance companies to the state.

4. The department would have to consider carrying insurance coverage to protect against extreme losses in a short period for the first few years. The cost of this type of coverage probably would not be great.

Estimated Reduction in Expenditures
Assuming the Cal-Vet Program Was Self-Insured For
Fire and Hazard Coverage for The
Period December 1960 through September 1974

	Insurance Costs By Contracting With Outside Companies		Self-Insurance Program Costs		Excess Of Insurance Costs By Contracting With Outside Companies Over Self-Insurance Program Costs
	Premiums	Lost Interest Income	Actual Losses (Claims) Paid To Cal-Vets	Administrative Expenses Of Self-Insurance Program	
1961	$ 2,534,000	$ 46,000	$ 53,000		
1962	2,410,000	128,000	314,000		
1963	2,252,000	203,000	683,000		
1964	2,362,000	279,000	1,117,000		
1965	2,122,000	363,000	1,267,000		
1966	2,508,000	462,000	1,662,000		
1967	2,212,000	560,000	1,588,000		
1968	2,461,000	684,000	1,934,000		
1969	2,584,000	893,000	2,057,000		
1970	2,306,000	969,000	2,262,000		
1971	3,379,000	887,000	2,211,000	$ 10,000	
1972	1,819,000	918,000	2,206,000	60,000	
1973	2,684,000	1,330,000	2,707,000	146,000	
1974	3,863,000	1,962,000	3,296,000	235,000	
Subtotals	$35,496,000	$9,684,000	$23,357,000	$451,000	
Prepaid portion of unearned insurance premiums which were refundable as of December 31, 1974	(5,700,000)				
Estimated unpaid losses and related administration expenses as of December 31, 1974			1,260,000	114,000	
Totals	$29,796,000	$9,684,000	$24,617,000	$565,000	$14,298,000